Nos. 28, 29

In the Supreme Court of the United States

OCTOBER TERM, 1944

CLARIDGE APARTMENTS COMPANY, AN ILLINOIS CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 183–199) is reported at 1 T. C. 163. The opinion of the circuit court of appeals (R. 228–237) is reported at 138 F. (2d) 962.

JURISDICTION

The judgments of the circuit court of appeals were entered on December 1, 1943 (R. 237–238). A petition for rehearing was denied on December 22, 1943 (R. 238). The petitions for writs of certiorari were filed on February 15, 1944, and were

granted on March 27, 1944. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

The taxpayer was formed in 1935 pursuant to a plan of reorganization under Section 77B of the Bankruptcy Act, and acquired all of the assets of the debtor company.[1] The old bondholders received stock of the taxpayer having a market value substantially less than the face amount of the bonds.

The principal questions, raised by the petition in No. 28, are:

1. Whether the issuance of taxpayer's stock to the debtor's bondholders resulted in a cancelation or reduction of indebtedness, within the meaning of Section 270 of the Bankruptcy Act, as amended (11 U. S. C. 670), to the extent of the difference between the face amount of the bonds and the market value of the stock issued in their place.

2. If a cancellation or reduction of indebtedness within the meaning of Section 270 is involved,

[1] In the Tax Court the Commissioner contended that the proceeding under Section 77B did not result in a "reorganization" within the meaning of the revenue laws, and that therefore the taxpayer was not entitled to use the debtor's basis in computing depreciation. The Tax Court held otherwise; and its conclusion in this respect was not questioned by the Commissioner in the circuit court of appeals, and is not challenged here.

whether that section is applicable to require a decrease in taxpayer's basis for the three tax years prior to 1938, the year in which the section was enacted.[2]

The subsidiary questions, raised by the petition in No. 29, are:

3. Whether the Tax Court erred in concluding that Section 270 required a decrease in taxpayer's basis for the year 1938 to the extent of the accrued unpaid interest on the bonds.

4. Whether the Tax Court's finding of the original cost of the assets should be sustained.[3]

5. Whether the court below erred in accepting the Tax Court's finding that the Commissioner

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[2] The taxpayer contended below that the principle of non-retroactivity also precluded the application of Section 270 to the tax year 1938, or at least that portion of the tax year 1938 which preceded September 22nd, the date upon which Section 270 became effective. (See R. 195–196). Both courts below held the section applicable to the entire tax year 1938. The taxpayer's contention in this respect has now apparently been abandoned; the prayer of the petition in No. 28 is that the Tax Court's decision be "affirmed on the points of non retroactivity and non cancellation of debt." See also brief in No. 28, pp. 2–3. The contention is to be distinguished from the contention, now made by the taxpayer for the first time, that Section 270 is totally inapplicable because the reorganization proceedings were no longer "pending" when Section 270 became effective. This new contention is treated in Point II of our argument, pp. 50–53, *Infra*. See also footnote 32, *infra*.

[3] If this Court accepts, as did the circuit court of appeals, the contentions of the Commissioner on the two principal questions, this and the preceding subsidiary question will become academic, since, regardless of the accrued un-

had properly disallowed certain deductions in 1937 on the ground that they were incurred and taken in 1936.

STATUTES AND REGULATIONS INVOLVED

This case involves primarily the construction of Sections 268 and 270 of the Bankruptcy Act (Act of July 1, 1898, c. 541, 30 Stat. 544, as amended by the Chandler Act, c. 575, 52 Stat. 840, and, as to Section 270, by c. 500, 54 Stat. 709; 11 U. S. C. 668, 670). These sections, together with certain related sections and the pertinent Treasury Regulations, are set forth in the Appendix, *infra*, pp. 63–72.

STATEMENT

The facts, as found by the Tax Court (R. 184–190), may be stated as follows:

The taxpayer is a corporation organized on May 28, 1935, under the laws of the State of Illinois, pursuant to a proceeding under Section 77B of the Bankruptcy Act. It filed its income and excess profits tax returns for the years 1935 to 1938, inclusive, with the Collector of Internal Revenue for the First District of Illinois. (R. 184.)

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paid interest, the amount of the cancellation or reduction of principal indebtedness occasioned by the substitution of stock for bonds in the reorganization would be sufficient to decrease the original cost basis, computed on any proposed theory, to an amount substantially below the fair market value of the property.

In determining deficiencies for these tax years, the Commissioner reduced the depreciation allowances claimed by the taxpayer (R. 9, 12, 15–16, 18–19), and disallowed certain deductions claimed for painting, decorating and repairs in the year 1937, on the ground that these expenses were incurred during the year 1936 and were claimed in the taxpayer's 1936 return (R. 15).

In 1924 the Claridge Building Corporation, taxpayer's predecessor (herein called the Building Corporation), had acquired a certain lot in Chicago from Charles F. Henry, who in consideration therefor received the Building Corporation's entire authorized capital stock. During the spring and summer of 1924, the Building Corporation caused an apartment building to be erected on the lot at a cost of $385,326.37. By August 1, 1935, depreciation amounting to $139,253.71 had been taken on a "cost" of $424,609.19, which included a contractor's commission to Charles F. Henry. (R. 184.)

On March 25, 1924, the Building Corporation issued its 6½ percent first mortgage bonds in the principal amount of $340,000. By October 1, 1931, the bonds were outstanding and unpaid in the principal amount of $277,000. Defaults having occurred both in principal and interest, the trustee filed a bill of foreclosure on October 1, 1931, and all of the bonds were declared immediately due and payable. A decree of foreclosure

was entered on February 19, 1932, but there was no sale of the mortgaged property under the decree and the foreclosure proceeding was never consummated. The trustee took possession of the property and collected the rents after October 1, 1931. (R. 184.)

On June 16, 1934, the Building Corporation filed a voluntary petition in the District Court of the United States for the Northern District of Illinois, Eastern Division, under Section 77B of the Bankruptcy Act as amended (R. 185).

On November 27, 1934, the bondholders' committee, the Building Corporation, and one Minnie H. Case agreed on a reorganization plan. The plan provided for the formation of a new corporation to acquire the property. The new corporation would have an authorized capital stock of 3,080 shares. Ninety percent of the outstanding stock, or 2,770 shares, would be held by trustees, and the trust certificates would be issued to the bondholders on the basis of one share of stock for each $100 face amount of bonds. Ten percent of the stock would go to the old stockholders. (R. 185.) This plan was confirmed and approved by the court by an order dated May 14, 1935. The order stated that the bonds and interest coupons were satisfied and of no further force and effect, and authorized the issuance of the new securities. (R. 187.)

The taxpayer was organized pursuant to the plan and the property was transferred to it (R.

188). Under the plan the taxpayer's stock was issued at the rate of one share per $100 face value of the bonds of the old company. The fair market value of the stock never exceeded $45 per share at any time during the year 1935. Of taxpayer's 3,080 shares of common no par value stock, 2,770 shares were issued to nondepositing bondholders and to trustees for the depositing bondholders. 308 shares were issued to old stockholders, and 2 shares remained unissued. (R. 189.)

The final decree in the Section 77B proceeding entered on March 1, 1937, declared the first mortgage bonds in the principal amount of $277,000 and interest coupons attached, and the trust deed and chattel mortgage which secured them, to be of no further force and effect as against the debtor or its property, and provided that the holders thereof should be entitled to receive only the new securities provided for in the plan of reorganization (R. 187).

The property in question, including the building and furnishings and the lot on which it was situated, was sold in July 1940 for $126,200, plus an assumption of about $20,000 of liabilities. The market in 1940 was much higher and more active than in 1935. The fair market value of the building, exclusive of the land, as of May 14, 1935 (the date on which the court confirmed the plan), was not in excess of $141,000. The fair market value of the land on that date was $16,000. (R. 190.)

The adjusted basis of the taxpayer's predecessor in 1935 was $239,377.33. At the date of the taxpayer's acquisition of the property the building had a remaining useful life of 25 years. (R. 190.)

The taxpayer reported its income and deductions on an accrual system of accounting and under this system deducted all expenses for painting, decorating and repairs in the year in which such expenses were paid. In 1936 it included in its expense deductions an amount of $1,219.44 for painting and decorating and $389.60 for repairs expended in that year. These identical items were deducted for a second time in the taxpayer's 1937 return. (R. 190.)

The Commissioner contended that the taxpayer's basis for depreciation of its property was its market value on acquisition in 1935, but the Tax Court concluded that the taxpayer had acquired the assets in connection with a reorganization within the definition of Section 112 (g) of the Revenue Act of 1934, as amended, and that therefore its basis for depreciation was the adjusted basis in the hands of the Building Corporation (R. 191–194). This conclusion was not challenged on appeal, and is not questioned here.

The Tax Court then considered the Commissioner's alternative contention that in the proceedings under Section 77B the Building Corporation's indebtedness had been "canceled or reduced" to the extent of the difference between the liabil-

ity on the bonds and the market value of the stock issued to the bondholders, and that therefore, under the provisions of Section 270 of the *Bankruptcy Act*, the basis had to be decreased by the amount of the reduction or cancellation (although not to an amount less than the fair market value of the property at confirmation of the plan). It held (R. 195–198): (1) that Section 270, having become effective on September 22, 1938, applied to the taxpayer's 1938 tax liability, but not to its liability for years prior to 1938; (2) that the issuance of the stock for the bonds was "not a cancellation or reduction of the liability represented by the bonds"; (3) that on the other hand the accrued and unpaid interest on the bonds was canceled, and that the interest so canceled could not be excluded from the write-down since the taxpayer had failed to establish it as "not resulting in a tax benefit on any income tax return"; (4) that the taxpayer was not entitled to include as part of the original cost of the building amounts allegedly paid by the Building Corporation for contractor's services, and that therefore the original cost of the building was $385,326.38, as determined by the Commissioner; and (5) that the taxpayer was not entitled to claim as a deduction for 1937 expenses for painting, decorating and repairs which had already been taken and allowed as a deduction for a prior year.

Both the Commissioner and the taxpayer appealed to the Circuit Court of Appeals for the

Seventh Circuit, the Commissioner questioning the correctness of rulings (1) and (2), and the taxpayer challenging (3), (4), and (5). The court below sustained the Commissioner's contentions with respect to all of these issues (R. 237-238).

SUMMARY OF ARGUMENT

The issues involved in No. 28 (discussed in Points I and II below) are plainly issues of statutory construction, and not subject to the principles of finality applied to decisions of the Tax Court in *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231. They are accordingly treated in this brief as clear-cut questions of law which are for decision by the courts.

I

The court below correctly held that when the bondholders in a bankruptcy reorganization receive stock in a new company having a market value less than the face amount of their bonds, the indebtedness represented by the bonds is "canceled or reduced" as those words are used in Section 270 of the Bankruptcy Act, as amended. This follows from the normal meaning of the comprehensive language used in Section 270, and is reinforced by consideration of the legislative and historical background against which Section 270 was formulated. It cannot reasonably be supposed that Congress, without indicating any

such purpose, intended to exclude from the broad, general language of Section 270 the type of cancellation or reduction of indebtedness which is one of the commonest features of bankruptcy reorganizations. No satisfactory rationale for exclusion of this situation from the operation of Section 270[4] is suggested either in the opinion of the Tax Court or in the brief of the taxpayer.

The contention that Section 270 was intended to operate only where the cancellation or reduction had created income which would have been subject to tax unless relieved therefrom by Section 268 is inconsistent with the positive language of Section 270, and with its legislative history, including the legislative history of its retroactive amendment in 1940. So to interpret Section 270 would defeat the primary purpose of Section 268, which was to eliminate the need for determining in particular cases whether under existing laws and precedents a cancellation or reduction of indebtedness created taxable income. Moreover, strong representations were made to Congress in 1940 that Section 270 should be amended so as to express the interpretation urged by the taxpayer in this case; but these representations were unsuccessful, and the amendment actually adopted followed the contrary proposal by the Treasury Department. The 1940 amendment must therefore be taken as an unequivocal acceptance by Congress of the view that Section 270 does not

depend for its operation upon the effectiveness of Section 268 to free from tax.

II

The court below was also correct in holding that Section 270 is applicable to all open tax years of corporations reorganized under Section 77B of the Bankruptcy Act, including tax years prior to 1938, the year in which Section 270 was adopted. The intention of Congress to make both Sections 268 and 270 thus retroactive is clearly indicated by Section 276c.(3), which expressly provides that both sections "shall apply to any plan confirmed under section 77B before the effective date of this amendatory Act". It is no answer to suggest that, under Section 276c.(3), Sections 268 and 270 are to be applicable to plans confirmed before 1938 but only in respect of 1938 and subsequent tax years. This suggestion neglects the fact that Section 268, which by its own terms operates *pari passu* with Section 270, can by its nature apply only to the tax year in which a plan of reorganization is confirmed. Congress can hardly have intended an accounting anomaly by virtue of which a tax benefit would be conferred in respect of a reorganization consummated in some year before 1938, while the correlative basis adjustment occasioned by the same reorganization would be required to be made only for 1938 and succeeding years.

The taxpayer here raises for the first time an alternative contention that Sections 268 and 270 are totally inapplicable to the case because the reorganization proceedings under Section 77B were no longer "pending" when the Chandler Act became effective. This contention, although plausible, neglects the fact that Sections 268 and 270 are essentially tax provisions. The contention would rest the incidence of tax consequences under these provisions upon a formality of reorganization procedure, rather than upon the substantive change of rights effected by the approval and consummation of a plan of reorganization.

That Congress could constitutionally provide retroactive application for Section 270 admits of little doubt, and is not seriously controverted here by the taxpayer.

III

Accrued unpaid interest on the Building Corporation's bonds in the amount of $80,002.20 was forgiven in the reorganization, and it is conceded that this forgiveness amounted to a "cancellation" of indebtedness within the meaning of Section 270. In the state of the record, the Tax Court was clearly correct in holding that the taxpayer's basis should be reduced by the amount of this interest forgiveness (to the extent that such reduction would not decrease the basis below fair market value). Interest forgiveness is to be ex-

cluded from the amount of the write-down only when "not resulting in a tax benefit on any income tax return," and the taxpayer failed to make any showing which would qualify it for the benefit of this exemptive provision. In so far as the record might possibly have supported a factual inference as to the absence of any tax benefit, the refusal of the Tax Court to draw such an inference affords no ground for judicial review.

IV

The court below properly declined to disturb the findings of the Tax Court as to the original cost of the building and as to the propriety of certain small deductions claimed in 1937 for decorating expenses. In the view which the circuit court of appeals took of the application of Section 270 to the reduction of indebtedness by satisfaction of the bonds, the question as to the original cost of the building was correctly held to be academic. If, by reason of the decision of this Court on the main issues in the case, that question loses its academic character, the decision of the Tax Court should be affirmed under the principles of *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231. The same disposition should in any event be made of the item of decorating expenses. Both issues were purely factual in nature, and depended upon testimony which was either conflicting, or vague and

uncertain. The final determination of such issues lay peculiarly within the province of the Tax Court.

ARGUMENT

In the forepart of its brief in No. 28 (pp. 8–11, 13–28) the taxpayer strenuously contends that the Tax Court's decision in its favor on the issues involved in that case should have been affirmed on the theory that the principles announced by this Court in *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231, either apply or should be extended to apply thereto.

No. 28 involves the meaning and application of Sections 268 and 270 of the Bankruptcy Act to undisputed facts. Such questions are clearly questions of statutory construction; nor can they be said to be peculiarly within the experience of the Tax Court. We do not understand that the opinion in the *Dobson* case forecloses the circuit courts of appeals from reviewing decisions on such questions. The later opinion of this Court in *Security Mills Co.* v. *Commissioner,* 321 U. S. 281, is clear authority for a reversal of a decision of the Tax Court which is found to have proceeded upon an erroneous construction of a statute. The jurisdiction of the appellate courts to review decisions of the Tax Court springs directly from act of Congress; Section 1003 (b) of the Revenue Act of 1926 (c. 27, 44 Stat. 9; 26 U. S. C. 1141 (c) (1)) provides: "Upon such review, such

courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require." The committee reports on this section make plain the congressional intent as to the scope of appellate jurisdiction conferred; they expressly state that circuit courts of appeals "upon review may consider, for example, questions as to * * * the proper interpretation and application of the statute or any regulation having the force of law * * *" (H. Rep. No. 1, 69th Cong., 1st Sess., pp. 19–20; S. Rep. No. 52, 69th Cong., 1st Sess., p. 36).

The taxpayer's contention that the principles of the *Dobson* case should be extended to the questions involved in No. 28 thus ignores the command of Congress as to the appellate jurisdiction of the circuit courts of appeals. The requested narrowing of appellate jurisdiction is clearly a matter of legislative policy, and should not be undertaken by this Court. Accordingly, we proceed to discuss the issues of statutory construction presented in No. 28 as clear-cut questions of law which are for decision by the courts. See *Dobson* v. *Commissioner*, 320 U. S. 489, 492–493.

I

THE PROCEEDING UNDER SECTION 77B IN WHICH THE TAXPAYER ACQUIRED ITS PROPERTY RESULTED IN A CANCELLATION OR REDUCTION OF INDEBTEDNESS REQUIRING THAT THE BASIS OF TAXPAYER'S PROPERTY BE DECREASED TO MARKET VALUE UNDER SECTION 270 OF THE BANKRUPTCY ACT AS AMENDED

Apart from the question of retroactivity, with which we deal under Point II of this brief, the taxpayer's argument regarding the applicability of Section 270 appears to rest on three main propositions. These three propositions, as we understand them, are:

1. That when bondholders in a bankruptcy reorganization receive, for their bonds, stock in a new company having a market value less than the face amount of the old bonds, no "indebtedness * * * has been canceled or reduced" as those words are used in Section 270, and therefore Section 270 is by its own terms inapplicable.

2. That even if Section 270 is in its literal wording applicable to the transaction, it must be construed together with Section 268, relating to relief from taxation, and as so construed requires readjustment of the basis only in cases where the cancellation or reduction is of a character which in the absence of Section 268 would give rise to a taxable profit.

3. That under the general provisions of the revenue laws as interpreted by the courts the issuance of stock under such circumstances, even

if resulting in a cancellation or reduction of indebtedness, would give rise to no profit taxable as income, and that since Section 268 is therefore inoperative to afford relief from tax, Section 270 is likewise inoperative to require a compensatory adjustment of the basis.

We contest the soundness of each of these propositions. An understanding of our views with respect to each of them will, we believe, be served by considering at the outset the relationship of Sections 268 and 270 to each other and to the statutory scheme of which they are a part.

The revenue statutes have long contained so-called "reorganization"[4] and "basis" provisions, designed in general to postpone the tax consequences of transactions regarded as "transitional, continuing transactions which are not sufficiently 'closed' to justify *economically* (though there may be a different answer on a strict *legal* basis) the imposition of capital gains tax at the immediate moment of an 'ordinary business' transaction."[5] The first "reorganization" provision appeared in the Revenue Act of 1918.[6] Readjustment of the

[4] The term "reorganization," as used in tax law, has a quite different scope from the same term as used with reference to corporate readjustments under the Bankruptcy Act. In the interests of clarity the term is placed in quotation marks in this brief whenever it is intended to refer to the tax concept.

[5] Paul, *Studies in Federal Taxation, Third Series*, pp. 4-5.

[6] Revenue Act of 1918, c. 18, 40 Stat. 1057, Section 202 (b).

"basis" of property acquired in a "reorganization" was not at first required, but it was soon recognized that the omission enabled many taxpayers to secure unintended tax benefits by engaging in exchanges of property which, while themselves tax-free, resulted in an increased cost basis for purposes of gain or loss, depreciation, and the like.[7] To remedy this "serious blunder", the first "basis" provision appeared in the Revenue Act of 1924.[8] Each succeeding revenue act contained similar provisions, changes being made from time to time on account of discovered loopholes,[9] or to afford additional relief.[10] A general revision appeared in the Revenue Act of 1934, and the provisions of that act were retained without substantial modification throughout the period involved in this litigation.[11] The general purpose of the "reorganization" pro-

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[7] Paul, *op. cit.*, pp. 23–24.

[8] Revenue Act of 1924, c. 234, 43 Stat. 253, Sections 204 (a) (6) and (7).

[9] Paul, *op. cit.*, pp. 36–41.

[10] E. g., Revenue Act of 1939, c. 247, 53 Stat. 862, Section 215.

[11] Sections 112 and 113 of the Revenue Acts of 1934 (c. 277, 48 Stat. 680), 1936 (c. 690, 49 Stat. 1648), 1938 (c. 289, 52 Stat. 447), and the Internal Revenue Code (26 U. S. C. 112, 113). The 1939 amendment referred to in the preceding footnote gave a measure of relief from tax liability upon the discharge of indebtedness. Section 121 (c) (3) of the Revenue Act of 1943, although changing the law prospectively with reference to corporations reorganized under the Bankruptcy Act, does not affect the tax years here in question. See footnote 29, *infra*.

visions is, in substance, to maintain free from immediate tax consequences what would otherwise be regarded as taxable gains and deductible losses; the "basis" provisions—requiring continued use of the transferor's basis in a tax-free "reorganization"—are designed to prevent the use of tax-free "reorganizations" as a means of securing stepped-up bases for depreciation and other purposes. The provisions complement each other; their general contemplation is that when the tax on an exchange is postponed through temporary nonrecognition, the taxpayer should by the same token be required to retain the original cost—to itself or to its predecessor, as the case may be—as a basis for future tax purposes. The provisions maintain the status quo with respect both to tax benefits and tax detriments.

This general pattern of "reorganization" and "basis" provisions under the 1934 Act was predicated on an assumption of continuity of interest in all parties, with a mere change in form of organization or form of indicia of ownership, insufficient in itself economically to justify either imposition of tax or readjustment of basis. The provisions apply to all exchanges falling within their terms; and when, in June, 1934, Section 77B of the Bankruptcy Act was adopted, the general "reorganization" and "basis" provisions of the revenue acts became equally applicable to reorganizations under that section, provided that they

met the test of what was a "reorganization" under the general standards of the revenue laws.

However, many reorganizations under Section 77B did not meet that test—or there was at least considerable doubt whether they did. It is a commonplace of bankruptcy reorganizations, predicated on insolvency, that the focus of interest shifts—that stockholders or junior creditors are reduced in interest or eliminated altogether, and the enterprise is handed over in whole or in greater part to the senior creditors. The case at bar is typical, the bondholders receiving a 90% interest in the stock of the new corporation and the old stockholders being reduced to a 10% participation. In many bankruptcy reorganizations the stockholders receive even less generous treatment. Moreover, a common phenomenon of bankruptcy reorganizations is the reduction of funded debt—since usually the need for reorganization is occasioned by excess of funded debt and other similar fixed charges. It was reasonable to suppose that such a reduction might under the doctrine of *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, create income which in the light of *United States* v. *Hendler*, 303 U. S. 564, would be taxable as such at the time of the reorganization.

Sections 268 and 270 of the Chandler Act were formulated against this background. The Chandler Act was a general revision of the provisions for

bankruptcy reorganizations, designed in part to strengthen judicial and administrative controls in the interests of fair and equitable reorganization plans, and in part to encourage the use of the bankruptcy reorganization mechanism so as to avoid unnecessary or premature liquidation of business enterprises. As noted above, the "reorganization" and "basis" provisions of the general tax laws applied, no less than in other areas, to an exchange occurring in a bankruptcy reorganization, provided that it met the statutory standards. The difficulty, however, was to determine whether in a particular case these standards were met. A guess made in advance might well later be held wrong by the courts, with heavy tax consequences to the reorganized company. The uncertainty of the law in this respect was such as to discourage in many cases the use of the bankruptcy reorganization mechanism.

In Sections 268 and 270, therefore, Congress undertook to deal with but one restricted corner of the "reorganization" field—corporate reorganizations through the bankruptcy process. It further limited its attention to a single aspect of bankruptcy reorganizations, the aspect of debt reduction, which, while it might or might not involve an exchange subject to the general "reorganization" provisions, was an almost invariable concomitant of bankruptcy reorganization. Section

268 is narrowly confined in its operation. It does not purport to alter the principles governing exchanges generally, nor to affect the basis of individual security holders acquiring new securities in the reorganization. In effect it provides, in exclusive relation to the debtor, the trustee, and the suceeding company, that whatever might be held to be the consequences of a debt reduction under the general "reorganization" provisions of the tax law, such a reduction in a bankruptcy reorganization shall have no direct tax consequences. It shall result in no tax "under any law of the United States or of any State now in force or which may hereafter be enacted."

To the extent that Section 268, in its narrow field, relieves certain common incidents of bankruptcy reorganizations from tax consequences, it parallels the "reorganization" provisions of Section 112 of the Revenue Acts. However, at that point the parallel ceases. Section 268 of the Bankruptcy Act is not, like Section 112 of the Revenue Acts, predicated on an assumption of continuing, open transactions. A bankruptcy reorganization possesses characteristics of finality not common to the ordinary "reorganization" contemplated by Section 112, which is often enough no more than a "mere change in the form of ownership."[12] Consequently, when it appeared

[12] See Paul, *Studies in Federal Taxation, Third Series*, p. 5.

that the draft of the Chandler Act originally considered by the House Committee contained no equivalent of the present Section 270—thus leaving the general "basis" provisions unaffected—the Treasury officials were prompt to suggest to Congress that in bankruptcy reorganizations the type of remission of tax envisaged by Section 268 would be unfair to the revenue unless complemented by a requirement for decrease of basis equivalent to the amount of the reduction of indebtedness.[13] Without such a requirement, a double deduction might result. Moreover, continued application of the general "basis" provisions to the typical bankruptcy reorganization whose principal feature was a reduction of indebtedness would be outside the scope of the purpose which originally motivated their adoption—the purpose of preventing the creation of a new stepped-up basis through the device of "reorganization." "Reorganizations"

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[13] Hearings before House Committee on the Judiciary on H. R. 8046, 75th Cong., 1st Sess., pp. 352–354; Hearings before Subcommittee of Senate Committee on the Judiciary on H. R. 8046, 75th Cong., 2d Sess., pp. 137–139, 145–146. The original Treasury suggestion, proposed in the House (Hearings, pp. 353–354), was that the decrease in basis be measured by "the extent of the amount of the exclusion from gross income to which the debtor is entitled under the preceding paragraph [i. e., the then equivalent of the present Section 268]." This suggestion was not followed, however: Section 270, as later proposed by the Treasury to the Senate, and as finally adopted, measures the decrease in basis by the amount of the reduction of indebtedness, without regard to the extent of remission of tax. See footnote 24, *infra*.

in the nature of mergers, consolidations, or recapitalizations were easily susceptible of manipulation so as to create a new, higher basis; a bankruptcy reorganization bringing about a reduction of indebtedness, whether or not it was likewise technically a "reorganization," could rarely lead to the same result.

Section 270, thus, is in the nature of an amendment to the general "basis" provisions of Section 113 in so far as they apply to one narrow aspect of bankruptcy reorganizations. Like Section 268, Section 270 is not concerned with exchanges generally, nor with the basis of reorganization-acquired property in the hands of security holders. Its effect, as originally adopted, was to provide that in any case of a bankruptcy reorganization where the general "basis" provisions were applicable, so that the debtor, the trustee, or the transferee under the reorganization plan would be required to continue to use the debtor's original basis, that basis should nevertheless be reduced by the amount of any cancellation or reduction of indebtedness occurring in the reorganization.

Doubtless, as originally adopted, Section 270 fulfilled its purpose of protecting the revenue. But it was soon found that the draftsmen had made a mistake—that they had made the section much too stringent. Witnesses appearing before a special subcommittee of the House Judiciary Committee in 1940 pointed out that under the

section as enacted the amount of reduction of indebtedness might be so great as to reduce the basis in the hands of the transferee to a point substantially below its fair market value, to zero, or even to a point below zero.[14] Two proposed solutions were discussed: (1) to provide for a decrease of basis "only to the extent to which taxable income would have been created by the reduction in indebtedness if such income had not been freed from taxation by section 268," and (2) to place a floor under the basis, preventing its decrease below fair market value at the time of reorganization.[15] The suggestions were not alternative means of reaching the same result; though both sought amelioration in the interests of promoting the use of the bankruptcy reorganization mechanism, their precise objects and their tax consequences differed widely. The former suggestion, designed by its sponsors to bring the bankruptcy situation into line with the general "reorganization" and "basis" provisions of the revenue laws,[16] was opposed by the Treasury De-

[14] Hearings before a special subcommittee on bankruptcy and reorganization of the House Judiciary Committee on H. R. 9864, 76th Cong., 3d Sess.

[15] See particularly Hearings, pp. 5–13, testimony of John Gerdes, chairman of the committee on reorganizations of the Commercial Law Section of the American Bar Association, and of the committee on bankruptcy and reorganization of the Association of the Bar of the City of New York.

[16] See Hearings, pp. 6, 56–61.

partment and others [17] as lacking in sufficient definiteness and certainty, and as producing undesirable tax results. This suggestion was accordingly rejected, and the section was amended retroactively to its present form, in which, while still requiring decrease of basis measured by the amount of reduction or cancellation of indebtedness, it provides that in no event shall the decrease be to a point "less than the fair market value of such property as of the date of entry of the order confirming the plan." [18]

Against this background, let us consider the several arguments of the taxpayer against the decision of the court below.

1. *The Section 77B reorganization in which the taxpayer acquired its property resulted in a cancellation or reduction of the Building Corporation's indebtedness to the extent of the difference between the face amount of the bonds and the market value of the stock received by the bond-*

[17] See Hearings, pp. 6–7, 15–18, 56–61.

[18] Dr. Gerdes in addition proposed a clarifying amendment designed to make clear that a cancellation or reduction of indebtedness should not be deemed to have taken place to the extent that the creditors received partial payment of their debts "in money, property, or shares of stock." See Hearings, p. 7. Otherwise, he pointed out, there was danger that Section 270 might be construed to require a decrease in basis even if cancellation of indebtedness had been accomplished through payment. The Treasury Department had taken no such extreme position in construction of the law, and the amendment was rejected, presumably as unnecessary.

holders.—The Building Corporation was obligated on its bonds in the principal amount of $277,000. The reorganization under Section 77B extinguished that entire indebtedness upon the issuance to the bondholders of 2,770 shares of the taxpayer's stock, having a market value of only $45 a share, or $124,650 in the aggregate (R. 189). The legal effect of the transaction, both under corporate law and under tax law, was that the indebtedness on the bonds was paid to the extent of the value of the stock, and the remainder of the debt—the difference between the value of the stock and the principal amount of the bonds—was canceled. To the extent of this difference the transaction constituted a plain case of reduction of indebtedness.

The taxpayer argues, and the Tax Court decided (R. 197), that "there was here no true reduction or cancellation of the original indebtedness, but what amounts to a continuation of it in another form," and that therefore neither the language of nor the reason for Section 270 of the Bankruptcy Act had any application to the case.[19] The Tax Court followed its own earlier decision in *Capento Securities Corp. v. Commissioner*, 47

[19] The statement quoted in the text from the opinion of the Tax Court somewhat undermines the force of the taxpayer's comment, at p. 44 of its brief in No. 28: "The statement of the court below that capital stock is not a debt is another straw man and false issue wholly immaterial to any question here presented. No one ever asserted it was a debt. The Tax Court was correct in terming it a liability."

B. T. A. 691, since affirmed in 140 F. (2d) 382 (C. C. A. 1). The *Capento* case involved no bankruptcy reorganization, and no question of [illegible]plication of Section 270. A going concern, des[illegible] a bank loan and being required by the bank to accord to the loan priority over its outstanding bonds, acceded to the suggestion of the bank that in order to facilitate the required priority the bonds, all of which were held by an affiliate, should be replaced by preferred stock having a par value equal to their face amount. The Board of Tax Appeals and the First Circuit Court of Appeals held that the Commissioner was in error in attempting in this situation to assess a deficiency in income tax against the issuing company measured by the difference between the face amount of the bonds and the market value of the preferred stock (which was substantially below its par value).

Whatever may be the correct tax result in a continuing transaction whereby, for mere purposes of corporate convenience and to facilitate the securing of a bank loan, a corporation changes the form of its outstanding securities held by an affiliate, we submit that the *Capento* case has no bearing on the problems involved in the case at bar.[20] Here, the Building Corporation entered

[20] In the *Capento* case the preferred stock had the same aggregate par value as the aggregate face amount of the bonds which it replaced. *Quaere*, whether the same result would have been reached if, as here, the stock had been without par value.

into a bankruptcy reorganization, motivated by the fact that it was and had long been unable to service its bonds, and that its property at current market values was worth substantially less than the face amount of the bonds. The substance of the reorganization plan was that the Building Corporation, being unable to pay its debts, turned the property over to its creditors in partial satisfaction thereof. To the extent of the value of the property thus turned over, the debt was paid in kind; to the extent of the difference, the debt was canceled.

Doubtless in technical accounting language common stock represents a balance sheet liability. But that is very different from concluding, as the Tax Court did (R. 197), that the substitution of stock for bonds represents merely a substitution of one form of debt for another. Common stock is not ordinarily thought of as representing a "debt" of its issuer, and its legal characteristics are totally dissimilar. As the court below held (R. 232):[21]

> * * * The acceptance of the stock for the bonds wiped out a direct debt liability, enforceable by legal action. The debt carried an interest obligation and priority of rights. The stock carried no right to interest and not even to dividends, unless surplus existed, and a declaration of distribution had been made. It carried no right

[21] Citing *Eyster* v. *Centennial Board of Finance*, 94 U. S. 500.

> to collect the sum represented by the investment therein. At best it is a right only to a proportionate distribution of the assets over and above all debts of the corporation, in case of liquidation.

That stock does not represent a debt is indeed axiomatic. When a debtor, unable to meet its debts, enters into a composition with its creditors whereby the entire debt is released in consideration of the transfer of property having a value equal only to a portion of the debt, the debt is obviously paid to the extent of the value of the property transferred, and canceled as to the balance. When the evidences of ownership of the property so transferred take the form of stock, the result is the same. To the extent of the value of the stock, the debt is paid. The balance of the debt is canceled.

The literal language of Section 270 leaves, we submit, no scope for any other conclusion. The words "canceled or reduced," as used in the section, are comprehensive, and cover just such a case as this. When words may be given their usual and ordinary meaning without violation of the scheme of a statute, or the legislative purpose, the sound rule of construction is that they be given that meaning. *DeGanay* v. *Lederer*, 250 U. S. 376, 381; *Avery* v. *Commissioner*, 292 U. S. 210, 214. Here, the scheme of the statute and the manifest legislative purpose emphasize the propriety of giving to Section 270 a construction in accordance

with the usual and ordinary meaning of its words.

As already pointed out (*supra*, pp. 21–22), Congress in enacting Sections 268 and 270 sought to encourage bankruptcy reorganizations as a means of rehabilitating illiquid business enterprises. Common experience teaches that the most usual factor motivating a bankruptcy reorganization is an excess of fixed charges in the form of bonded indebtedness, and that the most usual means of reducing these fixed charges to a point at which they can successfully be borne by the enterprise is to cancel them in whole or in part, and in compensation to turn the property over, in whole or in part, to the bondholders. The taxpayer itself asserted, as one of the reasons urged for granting the writ in No. 28, that the question "whether debt is 'canceled or reduced' in circumstances such as this exists in hundreds of 77B reorganizations" (Pet. in No. 28, p. 5). Accordingly, the instant case could hardly be excluded from the operation of Section 270 without substantially eviscerating the section. Certainly no such result should be reached without some convincing rationale of exclusion.

The taxpayer's proposed rationale of exclusion is far from convincing, and appears to us to be entirely without reasonable basis in the language or purpose of Section 270. According to the taxpayer (Br. in No. 28, pp. 39–40; see also Pet. in No. 28, p. 9), a debt is to be regarded as

"canceled" only when it is accorded no recognition in the plan, and as "reduced" when it is "recognized only in part." As a premise, this distinction is faulty, since Section 268 specifically mentions "cancelation in whole or in part of any of the indebtedness of the debtor." However that may be, on this premise the taxpayer attempts to distinguish between senior and junior debt, contending that if the value of the property exceeds the first mortgage but cannot meet the second mortgage in full, the second mortgage is "recognized only in part," and therefore "reduced" within the meaning of Section 270, whereas if the second mortgage is wiped out and the first mortgage bondholders receive all the property, "the full amount of the senior debt is recognized" regardless of the value of the property. We submit that the statute affords no warrant for a construction which would thus confine its operation to the settlement of the claims of junior creditors. Even were the distinction tenable logically, precise statutory language would be necessary to justify so great a restriction on the operation of a provision designed to establish a rule applicable to all indebtedness which is eliminated or reduced in a bankruptcy reorganization.

2. *The operation of Section 270 to require a decrease in basis measured by the amount of a cancellation or reduction of indebtedness is not dependent on the extent of relief granted in the*

particular case by Section 268.—The taxpayer contends that Section 270 is intended to require a decrease of basis only in cases in which Section 268 has operated to relieve from tax. On this assumption, the taxpayer argues that Section 270 is inapplicable here, either on the ground that the income, if any, created by the cancellation of indebtedness was already exempted by Section 112 (b) (4) of the Revenue Act of 1934, the general "reorganization" provision, and therefore needed and could secure no additional exemption from Section 268 of the Bankruptcy Act, or on the ground that the cancellation of indebtedness created no income of any kind which could have been subject to tax (Br. in No. 28, pp. 33–35, 41).

We are not prepared to concede the taxpayer's argument that a cancellation of indebtedness under circumstances of the type involved in this case creates no income which would be subject to tax. Admittedly, the law in respect of the taxable status of cancellation or forgiveness of indebtedness has long been in an uncertain state, but it seems entirely possible that the considerations delineated by this Court in the recent case of *Helvering* v. *Amer. Dental Co.*, 318 U. S. 322, might lead to the conclusion that the cancellation involved in this case produced income taxable as such under the doctrine of the *Kirby Lumber Company* case, 284 U. S. 1. However, we take no position on that issue here, in view of the patent unsoundness of

the petitioner's contention that the operation of Section 270 is dependent upon the effectiveness of Section 268 to relieve from tax.

In the first place, there is no warrant in the language of Section 270 for construing it as operative only to the extent that Section 268 has afforded in the particular case a relief not otherwise available. The taxpayer would read the statute as if it required that the basis "shall be reduced by the amount of gain not recognized by Section 268." But the statute does not so require. It provides, without reference to Section 268, that the basis—

> shall be decreased by an amount equal to the amount by which the indebtedness of the debtor * * * has been canceled or reduced in a proceeding under this chapter. * * *

Thus, though the event which sets in action the basis provision of Section 270 is the same event as occasions the application of Section 268, nothing in either section, or elsewhere in the Bankruptcy Act, makes the action of either dependent upon the operation of the other. Section 268, for instance, might relieve from a tax while Section 270 was in whole or in part inoperative because of the fact that the fair market value of the property was the same as or higher than the debtor's basis, or, as here, higher than the debtor's basis as decreased by the amount of the canceled debt. By the same token, Section 270 may require a de-

crease of basis even though the relief from tax contemplated by Section 268 was already afforded by some other provision of law. The mere fact of a complementary general purpose does not require complementary action as a condition of application in any given case.

That this is the correct view is shown by the consideration we have already given (*supra*, pp. 18–27) to the historical background and purposes of Sections 268 and 270. This Court has recognized the purpose of Congress in these sections to redeem at least the bankruptcy situation from judicial and administrative confusion regarding the application of income tax law to debt reductions. "The uncertainties of the effect of the remission of indebtedness on income tax brought about legislation to clarify the problems. The Chandler Bankruptcy Act of June 22, 1938, instituted adjustments deemed desirable." *Helvering* v. *Amer. Dental Co.*, 318 U. S. 322, 328. In 1938 the *Kirby Lumber Company* case, 284 U. S. 1, was already on the books, justifying the view, or at least the fear, that a reduction of bond liability might result in a tax to the debtor. *United States* v. *Hendler*, 303 U. S. 564, narrowing the scope of the general "reorganization" provisions in relation to discharge of bond indebtedness, had been decided in March of 1938. The decisions of this Court in 1942 elucidating the "continuity of interest" test applicable under the general "reorganization" provisions were as yet

unwritten.[22] In this atmosphere of confusion Congress attempted to bring certainty at least to the bankruptcy reorganization field, by providing that, whatever might be the tax effect of a cancellation or reduction of indebtedness under the general "reorganization" provisions, such transactions should occasion no tax when effected in a bankruptcy reorganization. This laudable congressional effort at clarity would be substantially frustrated by the taxpayer's proposed construction. In every case it would still be necessary to determine what would have been the tax consequences of a given cancellation or reduction under the general "reorganization" provisions, since until such a determination had been made it would be impossible to decide whether Section 268 afforded relief not already available under some other provision of law. That task may by now have lost some of its difficulty; but the statute must be construed in the light of the problem confronting Congress in 1938.

Any doubt which might otherwise exist is resolved by the fact that the view urged by the taxpayer has already been heavily pressed upon Congress as grounds for amendment of the Act and

[22] *Helvering* v. *Limestone Co.*, 315 U. S. 179; *Palm Springs Corp.* v. *Commissioner*, 315 U. S. 185; *Bondholders Committee* v. *Commissioner*, 315 U. S. 189; *Helvering* v. *Southwest Corp.*, 315 U. S. 194; *Helvering* v. *Cement Investors*, 316 U. S. 527. The "continuity of interest" test had been introduced in *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462, and elaborated in *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378, and *LeTulle* v. *Scofield*, 308 U. S. 415.

has been rejected. At the hearing on the amendment of Section 270 in 1940 (discussed at pp. 25–27, *supra*) it was contended that Congress, notwithstanding the language of the section, had intended to make its application dependent upon the effectiveness of Section 268 to relieve from tax. Witnesses at the hearing so testified, and sought to modify the proposed amendment so as to reestablish what they asserted was the original purpose.[23] The Treasury, abandoning its original position before the House Committee,[24] re-

[23] See testimony of Charles S. Banks, representing the National Bankruptcy Conference, and letter from former Representative Walter Chandler, who had sponsored the original Chandler Act, Hearings on H. R. 9864, 76th Cong., 3d Sess., pp. 56–61.

[24] As pointed out in footnote 13, *supra*, the original Treasury suggestion, made in the 1938 House hearings, had been that the decrease in basis be measured by "the extent of the amount of the exclusion from gross income to which the debtor is entitled under" Section 268. It was to this original suggestion that Mr. Kent, Assistant General Counsel of the Treasury, had directed the illustration which the taxpayer cites (Br. in No. 28, p. 32) as showing the Treasury intent. The bill reached the Senate without any equivalent of Section 270, and at the Senate hearings Mr. Kent furnished a similar illustration, together with other illustrations showing a somewhat broader objective. Hearings before Subcommittee of Senate Committee on the Judiciary on H. R. 8046, 75th Cong., 2d Sess., pp. 137–139, 145–146. Discussions followed between Mr. Banks and the Treasury representatives, as a result of which the Treasury submitted a draft of Section 270 as it was finally adopted. The testimony of Mr. Banks in connection with the 1940 amendment (Hearings on H. R. 9864, pp. 59–60) shows clearly that by the time this final draft was submitted the Treasury Department had modified its earlier views as to the proper scope of a provision requiring reduction in basis.

sisted the suggested modification, and pressed for the "floor" provision, which was finally adopted and which both its supporters and opponents admitted would relieve some of the hardships created by Section 270 without, however, making its operation contingent upon relief under Section 268.[25] In the face of this legislative history of a retroactive amendment, the intention of Congress in the matter is hardly open to further question.[26]

To summarize our construction, therefore, Section 270 is not confined in its application to those cases where Section 268 grants relief not otherwise accorded by the tax laws. The taxpayer's construction would effectively nullify the underlying objective of Section 268 to free all parties

[25] See testimony of Gerdes, Hearings on H. R. 9864, pp. 6–13; Statement of John L. Sullivan, Acting Secretary of the Treasury, *id.*, pp. 15–18; testimony of Banks, *id.*, pp. 56–61.

[26] Section 22 of the Internal Revenue Code was amended by Section 215 of the Revenue Act of 1939 to afford generally to corporations "in an unsound financial condition" a limited measure of relief from income tax liability upon the discharge of indebtedness, comparable to the relief afforded by Section 268 of the Bankruptcy Act. On the reasoning of the taxpayer, presumably Section 270 of the Bankruptcy Act would be inapplicable in cases since 1939 where the relief afforded by Section 268 merely duplicated relief also available under the 1939 amendment to the Code. In other words, the 1939 amendment to the Code would serve further to narrow the scope of Section 270. Yet the legislative history of the 1939 amendment shows that it was not intended to affect cases under the Bankruptcy Act. H. Rep. No. 855, 76th Cong., 1st Sess., p. 5.

from the need of solving, for income tax purposes, the vexing questions whether a "reorganization" was involved, whether the cancellation or reduction created income, and whether if so it amounted to a tax-free exchange. Section 270 still requires determination whether a "reorganization" was involved, since only in such a case would the transferee be a "person required to use the debtor's basis";[27] but once that is established, the application of Section 270, like that of Section 268, is automatic. Determination of the existence of income, or of exemption under the general revenue laws, is dispensed with.

Against this construction of Section 270, which we believe impelled by its language and history, it may be argued that a Congress desiring to encourage use of the bankruptcy process for the rehabilitation of embarrassed business enterprises can hardly have intended to impose upon enterprises reorganized in bankruptcy a tax penalty, in the form of reduced basis, not incurred by enterprises reorganized through other means. It may be conceded that Section 270 is not a model

[27] See letter from Banks, representing the National Bankruptcy Conference, Hearings (Senate) on H. R. 8046, 75th Cong., 2d Sess., pp. 210–211: "* * * I accept the Treasury Department's viewpoint, that unless it is a case wherein the transferee is required under the revenue laws to use the debtor's basis, it would be best, in fact, necessary, to use cost to the transferee, thus accepting the Revenue Act and Treasury Regulations as the test of whether or not a reorganization under the Bankruptcy Act is a nontaxable reorganization."

of perfection, and that it did not, either originally or as amended, in all respects achieve the aims of its framers. Deficiency in this respect is hardly a rare phenomenon in reorganization tax law, whether formulated through legislation, administration, or judicial interpretation. There is probably no field of law in which the process of trial and error has required more repeated revision of the legal framework in order to meet new conditions, or to remedy the unforeseen consequences of earlier pronouncements.[28] That Congress in 1938 may not have anticipated fully the consequences of its attempt to prevent a double deduction, which might otherwise have been available through the operation of Section 268 when coupled with the "basis" provisions of the Internal Revenue Code, is therefore an insufficient reason for unduly narrowing the scope of Section 270. Indeed, the retroactive amendment of Section 270 in 1940, providing that the basis should not in any event be reduced below the fair market value of the property, makes plain a congressional realization that in 1938 it had failed to envisage the full consequences of its original action.[29] Furthermore,

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[28] See, generally, Paul, *Studies in Federal Taxation, Third Series, sub. cap.* "Reorganizations," pp. 3–165.

[29] Cf. also the revision effected by Section 121 of the Revenue Act of 1943, Pub. L. 235, 78th Cong., 2d Sess. This amendment was prospective only, a fact which negatives the taxpayer's suggestion (Br. in No. 28, pp. 36–37) that the amendment in some way establishes a congressional intent in 1938 and 1940 inconsistent with the view we urge here.

the 1940 amendment serves to reduce materially the force of the criticism which prior to amendment was leveled at Section 270, as imposing a deterrent to bankruptcy reorganizations.[30] By virtue of the amendment the bondholders no longer risk taking over the property at a zero basis. While even under the amendment a decrease in basis may still be required which would not have been necessary had the same reduction of indebtedness been effected by reorganization outside of bankruptcy, it was surely not unreasonable for Congress to have regarded such a decrease as peculiarly appropriate in the special field of bankruptcy. For bankruptcy reorganization presents special benefits in the shape of opportunities to embarrassed business enterprises to tailor their

[30] See Darrell, *Discharge of Indebtedness and the Federal Income Tax*, (1940) 53 Harv. L. Rev. 977, 1009–1010; Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, (1940) 49 Yale L. J. 1153, 1186–1188; Warren and Sugarman, *Cancellation of Indebtedness and Its Tax Consequences: II*, (1941) 41 Columbia Law Rev. 61, 72–81; Paul, *Debt and Basis Reduction under the Chandler Act*, (1940) XV Tulane L. Rev. 1, 8–10. It may be noted that in the last mentioned article, much cited in the taxpayer's brief in No. 28, Mr. Paul, while recognizing "baffling problems arising out of Sections 268 and 270", comments that Section 270 literally "called for an automatic reduction of basis even though it constituted a contribution to the corporate capital, and even though for some other reason it was not recognizable income," and that the language of the section "seemed too plain to countenance deviations from a rigid general rule." *Op. cit.*, pp. 2, 6, 8.

structures and obligations to their actual business prospects, and to slough off permanently prior commitments which by the logic of events have proved incapable of fulfillment. Whatever might be the considerations applicable in other fields, it is entirely reasonable that in bankruptcy reorganization neither the debtor nor its proprietors (old or new) should be permitted to benefit from a cancellation or reduction of indebtedness unless that benefit should be reflected in future income through reduction of basis.

The old bondholders may, of course, complain that they have already had to sustain a loss in writing off the difference between the value of the property and the full amount of their claims; but, realistically viewed, that loss was not occasioned by the reorganization. By the time of commencement of reorganization their claims had an actual value to them no greater than the value of the property. When they take over the enterprise they take it over in sound financial shape, freed of obligations which had hampered the old proprietors and made successful operation impracticable. New proprietors who have received what thus amounts to an actual decrease in cost, or increase in net worth, have no sound ground for complaint that they are not permitted to duplicate their advantage by a continuation, for tax pur-

poses, of the original pre-reorganization cost of the property.[31]

II

SECTION 270 OF THE BANKRUPTCY ACT, AS AMENDED, IS APPLICABLE TO THE FOUR TAX YEARS IN QUESTION

The Tax Court held not only that the principal amount of the bonds was not "canceled or reduced" in the reorganization so as to bring Section 270 into play, but also that even as to the interest, which it agreed had been "canceled or reduced," Section 270 was inapplicable except in respect of the tax year 1938, the year in which the section was enacted.[32] In so holding, the Tax Court followed its own earlier decision in *The*

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[31] It is incorrect to assume, as the taxpayer does, that Section 270 invariably works a hardship on bondholders who take over the property in satisfaction of their claims. Cf. the analysis of Gerdes, Hearings on H. R. 9864 (footnote 14, *supra*), pp. 5-13, showing that the alternative proposal, equivalent to the taxpayer's proposed construction, could in certain financial situations work equal hardship. Congress was faced with the need of choosing between two proposed tax mechanisms, neither of which was considered entirely fair or satisfactory. Moreover, there was strong feeling in the congressional committee that, other things being equal, the nation's need in 1940 for protection of the revenue should be accorded paramount consideration. See Hearings on H. R. 9864, pp. 9, 22.

[32] As indicated in footnote 2, *supra*, p. 3, the taxpayer has now apparently abandoned its contention, made below, that the principle of nonretroactivity precluded the application of Section 270 to the tax year 1938, or at least that portion of the tax year 1938 which preceded September 22nd, the date upon which the section became effective. We treat below, pp. 50-53, the new, alternative argument that Section 270 is

Commodore, Inc., 46 B. T. A. 718; and the decision of the court below in the instant case, extending the application of Section 270 to the tax years 1935–1937, is in square conflict with *Commissioner* v. *Commodore, Inc.*, 135 F. (2d) 89 (C. C. A. 6), in which the view of the Tax Court was upheld. We submit that the view of the court below, contrary to that of the Tax Court and the Sixth Circuit Court of Appeals, is correct.

It is of course true, as the court below recognized, that retroactive effect is not to be given to legislation unless the retroactive purpose "is expressly stated, or is to be inferred by clear intent, or by the necessary and unavoidable implications of the legislation." Here, both the language of the statute, and the necessary implications of the legislative policy which it was designed to effectuate, impel the conclusion that retroactive effect was intended to be given to it.

inapplicable to all the tax years in question because it applies only to plans of reorganization adopted in proceedings "pending" at the time it became effective. The taxpayer asserts, accurately (Br. in No. 28, p. 47), that the Tax Court "did not decide the question"; the reason for the Tax Court's failure, however, appears to be that the question was not presented to it. On the basis of the arguments which were presented to it, the Tax Court held specifically (R. 195) that the applicability of Section 270 to the tax year 1938 is "not subject to serious doubt."

R. 234, citing *Hassett* v. *Welch*, 303 U. S. 303; *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; Mertens, *Law of Fed. Income Taxation*, Sec. 3.33; *Brewster* v. *Gage*, 280 U. S. 327.

The statutory language is clear. The scope of application of Section 270 is specifically covered in Section 276.c, which provides:

> (3) sections 268 and 270 of this Act shall apply to any plan confirmed under section 77B *before the effective date of this amendatory Act* and to any plan which may be confirmed under section 77B on and after such effective date, * * * [Italics supplied.]

In this case the plan was confirmed under Section 77B before the effective date of the Chandler Act, September 22, 1938. "Given their ordinary meaning," as the court below said (R. 235), the words of Section 276.c (3) leave no room for doubt that the plan was subject to Section 270.

The taxpayer contends, however, that in so deciding the court below "decided a false issue not in dispute and not an answer to this issue" (Br. in No. 28, p. 45). The taxpayer's contention, apparently, is that to concede the application of Section 270 to this plan is a very different thing from conceding that as so applied it requires readjustment of basis for tax years prior to the Act's effective date. According to the taxpayer, the Act says at most "that from the year of its enactment it applies in computing tax liability of 'any plan confirmed before the effective date of this amendatory Act'" (Br. in No. 28, pp. 45–46).

If this is the correct construction, the language of Congress is remarkably inept to convey its

meaning. Nothing would have been easier than to provide specifically that "on and after the effective date of this amendatory Act" Section 270 shall apply to plans earlier confirmed under Section 77B. The fact that Congress failed to follow so direct a path argues strongly that that was not the path it intended to follow. Congress was dealing not with tax consequences resultant from the enactment of the Chandler Act, but with the tax consequences of bankruptcy reorganization plans adopted under Section 77B. Section 276.c (3) by its terms is concerned with the application of Section 270 to "plans," not to tax years. The significant date in fixing the tax consequences of a plan is the date of the effectuation of the plan, not the date of effectiveness of the Chandler Act.

This conclusion, we submit, is reinforced by consideration of Section 270 in its context. As shown above, Sections 270 and 268 are complementary. Their interrelationship is recognized in the opening clause of Section 268 itself. Though Section 270 does not depend for its operation upon the actual granting of relief by Section 268 in the particular case, yet the two sections present facets of the same stone. The event—cancellation or reduction of indebtedness—which sets in motion the tax consequences of one brings the other also into play. It can hardly be doubted that if one is retroactive, so must the other be. Section 276.c (3) allows no distinction between them in this respect.

Yet it is clear that Section 268 is, and in its nature must be, retroactive. Section 268 covers the taxability of income created by the act of reorganization. The profit to which it refers, and which it excludes from tax, is a profit made at the moment of effectuation of the plan, and which if it were taxable at all would be taxable only as of that moment. The tax consequences, in terms of relief or benefit to the taxpayer, thus necessarily occur in the year when the plan takes effect; they can occur in no other.[39] And orderly administra-

[39] Accordingly, the Treasury Regulations under the Revenue Acts of 1934 and 1936 were retroactively amended in 1938 to provide specifically that no income should be deemed to have been realized in the case of a cancellation or reduction of indebtedness under a plan of corporate reorganization confirmed under Section 77B of the Bankruptcy Act. See: Articles 22(a)-14 of Regulations 86 and 94, as amended by T. D. 4871, 1938-2 Cum. Bull. 130, 132-133, Appendix, pp. 65-68, *infra*. Articles 113(b) of Regulations 86 and 94 were likewise retroactively amended at the same time by the addition to each of a new Article 113(b)-2, dealing with the adjusted basis required by Section 270 in the case of a cancellation or reduction of indebtedness under Section 77B. *Id.*, pp. 133-135. Articles 113(b)-2 as thus added were retroactively amended in 1940 to reflect the 1940 "fair market value" amendment of Section 270. T. D. 5003, 1940-2 Cum. Bull. 107, 108-109; see Appendix pp. 68-72, *infra*. Tax benefits have thus been accorded both by Treasury Regulations and by Treasury practice under Section 268 for all open years preceding the adoption of Sections 268 and 270 in 1938, regardless of whether the reorganization was still pending when those sections became effective. The weight to be accorded to a Treasury Department interpretation thus formally expressed in a regulation and pursued in practice needs no citation of authority.

tion of the complementary features of Sections 268 and 270 plainly requires that the tax consequences in terms of reduction in basis should begin at the same time. It is, we submit, unreasonable to suppose that Congress, having made certain of relief from tax effective in the year of the reorganization, intended a windfall to taxpayers by permitting continued use of the transferor's basis for that year and all ensuing years down to 1938.

These are the considerations which we believe underlay the statement of the Senate Judiciary Committee from which the taxpayer here seeks to draw comfort.[35] It is true that the Senate Committee referred to reduction of basis "for future tax purposes." But the concept of futurity necessarily demands relation to a specific event. The taxpayer would identify that event as the coming of the Chandler Act into effectiveness, thus disregarding, for all years prior to 1938, the expressed intent of the Senate Committee "to prevent a double deduction." To avoid this unwelcome result, the event must, we submit, be identified as the event which created the danger of double deduction—the act of reorganization. When that event happens, then "for future tax purposes"—i. e., for tax purposes following that event—the basis must be reduced.

[35] S. Rep. No. 1916, 75th Cong., 3d Sess., p. 39. See Br. in No. 28, pp. 33, 46.

This natural reading of the Senate Committee Report comports with normal accounting practice. Indeed, it may be said as a general proposition that an adjustment of basis by reason of a given past event would instinctively be thought of as retroactive to the date of that event. Such an adjustment is designed, among other things, to create a continuing and equal effect upon the computation of depreciation in any and all years subsequent to the adjustment. To make the adjustment effective for only some of the years subsequent to the event which gave reason for the making of the adjustment would create an accounting anomaly; by changing the basis in midstream it would defeat the accounting objective of setting up a uniform depreciation over the entire period of estimated useful life. If, merely to avoid the charge of retroactivity, Congress had designed so irrational a result as a basis adjustment beginning with an event irrelevant to the need for adjustment, we must surely assume that Congress would have said so in clear language.

There is more merit in the taxpayer's alternative contention (Br. in No. 28, pp. 47–50) that Section 270 is inapplicable to this case as a whole because of the fact that the reorganization proceedings pursuant to which the taxpayer was formed were no longer "pending" when the Chandler Act was adopted, having been terminated by a final decree entered on March 1, 1937 (R.

187). As a matter of statutory construction it is a plausible argument that Section 276c.(3), in providing for the application of Sections 268 and 270 to "any plan confirmed under section 77B" before September 22, 1938, was intended merely as a modification of the general direction that Section 77B should continue to govern cases originated under that section and still pending when the Chandler Act became effective. However, there is serious doubt whether this contention is open to consideration at the present time. The contention, so far as appears, was not raised in the courts below; and though it was adumbrated in the petition in No. 28 (pp. 19–20), it is inconsistent with the relief prayed in that petition, which was affirmance of the Tax Court's decision that Section 270 applied to the tax year 1938. Moreover, the contention, although plausible, is not, we submit, convincing. The express provision of Section 276c.(3) is that Sections 268 and 270 "shall apply to any plan confirmed under section 77B"—not to any plan so confirmed in a proceeding still "pending" on September 22, 1938. Sections 268 and 270, although contained in a reorganization act, are essentially provisions of tax law, and as such must reasonably be assumed to relate to events which are significant from the point of view of tax law. In the procedure of reorganizations a final decree may be important as tying up the loose ends of administration, discharging

the responsibility of officers of the court, and formally closing the case as a matter of court record. The actual change of rights, however, which motivates tax consequences, does not wait upon final decree; it is customarily—as it was here (R. 84–91)—effected by the order confirming the plan. By that order new interests are created, the enforcement of old claims is barred or enjoined, the contours of the reorganization are, for all practical purposes, irrevocably fixed. Even the reservation of judicial jurisdiction is confined to the entry of further orders "necessary and proper in connection with carrying out the terms and provisions" of the plan already judicially approved and factually consummated in all but procedural respects. The *locus poenitentiae* suggested by the taxpayer (Br. in No. 28, p. 49) as still persisting prior to final decree is more theoretical than real; regardless of the entry of final decree, the unravelling of a plan of reorganization once approved and consummated would pose practically insuperable mechanical obstacles. If, as we believe,—and as the taxpayer for this branch of its argument concedes—Congress in Sections 268 and 270 of the Bankruptcy Act sought to revise the tax consequences of Section 77B reorganizations for at least some tax years preceding 1938, it is irrational to suppose that the effectiveness of the revision was intended to depend upon the fortuitous circumstance of the speed with

which the officials in charge might have happened to wind up the clerical and administrative details and secure their quittance from the court.

In support of both its alternative contentions the taxpayer seeks to enlist a general judicial reluctance to retroactive construction of legislation. However, retroactivity, although not to be presumed in the absence of indications of legislative intent, is not in itself either extraordinary or improper in tax legislation, and in relation to basis adjustments may even be said to be normal.[30] Nor does such retroactivity, as the taxpayer suggests (Br. in No. 28, p. 47), infringe its constitutional rights. It is well established that a tax is not necessarily unconstitutional because retroactive. *Milliken* v. *United States*, 283 U. S. 15, 21. In *Welch* v. *Henry*, 305 U. S. 134, this Court explored in some detail the considerations bearing upon the possible unconstitutionality of retroactive tax features, approaching the question with sensitive regard for the "delicate and difficult task" of equitably distributing the costs of government through the medium of an income tax. As the Court there said (p. 147):

> In each case it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said that

[30] Occasionally the Revenue Acts have altered the computation prospectively from the year of enactment, but this has been done by specific statutory treatment. See, e. g., Section 121 (c) (3) and (e), Revenue Act of 1943, Pub. L. 235, 78th Cong., 2d Sess.; cf. *id.*, Section 122.

> its retroactive application is so harsh and oppressive as to transgress the constitutional limitation.

As *Welch* v. *Henry* shows, the extent of the statute's retroactive reach in point of time may be one element bearing upon its constitutionality; and the decision of that case doubtless goes no further in this respect than "that the 'recent transactions' to which this Court has declared a tax law may be retroactively applied * * * must be taken to include the receipt of income during the year of the legislative session preceding that of its enactment" (p. 150). But the opinion conveys no implication of the decisiveness of a mechanically applied time factor. Here, the reasonableness of the time factor is to be gauged by its relationship to the congressional purpose of affording retroactive relief in Section 77B reorganizations. Section 270 is not so much a new tax, levied upon a freshly selected object theretofore supposed to be free of tax, as it is a condition or qualification of a tax benefit which Congress decided to confer retroactively in order to avoid hardship. From the hindsight of four years' experience with Section 77B, Congress found judicial and administrative confusion in the taxation of income arising from cancellations of indebtedness, and determined to cut the Gordian knot by a special exemption

which would settle the question for Section 77B reorganizations, regardless of what might ultimately be held to be the correct rule in other situations.[37] In these circumstances, the imposition of a compensatory basis requirement coterminous with the relief provision, even though in individual cases it might result in an upward revision of tax for open tax years, is, we submit, neither harsh nor oppressive within the meaning of the due process clause as it has hitherto been interpreted by this Court.[38]

[37] The taxpayer suggests (Br. in No. 28, pp. 53–54) that under our construction Section 270 might be applicable to some reorganizations which had been consummated in 1934 and which therefore, because of the three-year income tax statute of limitations, could have secured no benefit from Section 268. However, Section 77B had become effective as recently as June 7, 1934, and in view of the time normally taken in working out and consummating reorganization plans it could reasonably have been supposed in 1938 that the number of reorganized corporations with tax years no longer open would be so small as to be negligible.

[38] The fact that in some individual cases Section 270 might apply to taxpayers who had received no relief by virtue of Section 268—because in the particular case even without Section 268 the reorganization might have been held tax-free—does not impeach the reasonableness of the congressional decision to eliminate uncertainties by a blanket exemption and to qualify the exemption in order to prevent undeserved windfalls. Cf. the doctrine applicable in police power cases, *Purity Extract Co. v. Lynch*, 226 U. S. 192, 201–202.

III

THE TAX COURT CORRECTLY HELD THAT SECTION 270 OF THE BANKRUPTCY ACT, AS AMENDED, REQUIRED A DECREASE OF THE TAXPAYER'S BASIS TO THE EXTENT OF THE ACCRUED UNPAID INTEREST ON THE BONDS

The Tax Court, although rejecting the Commissioner's contention that Section 270 required a decrease in the taxpayer's basis to the extent of the difference between the principal of the bonds and the value of the stock, nevertheless held (R. 197) that for the year 1938—the only year for which the Tax Court conceded the section's application—such a decrease was required to the extent of $80,002.20 of accrued unpaid interest.[39] The circuit court of appeals found it unnecessary to discuss the correctness of this holding, since the decrease which it held to be required by the cancellation or reduction of principal was in any event sufficient to lower the basis to the "floor" or fair market value of the property.[40] The question will similarly remain academic in this Court unless the Court should reverse the judgment below on the

[39] Section 270 by its terms excludes from the write-down requirement "accrued interest unpaid," but only if "not resulting in a tax benefit on any income tax return."

[40] Although the circuit court of appeals failed to discuss the interest question, its conclusion and mandate purported to affirm the decision of the Tax Court thereon (R. 237). It would thus seem that the courts below agreed on the disposition of this issue.

issue treated in Point I of this brief.[41] However, since this Court granted certiorari in No. 29 as well as in No. 28, we discuss the question as if the decision on Point I were adverse to our contentions.[42]

We do not understand the taxpayer to contend that the accrued unpaid interest was not "canceled" within the meaning of Section 270. Rather, the taxpayer relies on the clause of Section 270 which excludes from consideration unpaid interest "not resulting in a tax benefit on any income tax return." The taxpayer contests the decision of the Tax Court on the ground that there was no evidence to show that any income tax benefit had been taken, and on the further ground that the question had not been properly placed in issue (Br. in No. 29, pp. 20–27).

[41] Of course, the question will also remain academic if this Court should disagree with both courts below, and hold that Section 270 is totally inapplicable to the case because the reorganization proceedings were no longer "pending" at the time of the adoption of the Chandler Act.. Assuming that this Court's decision on the main issues (treated in Points I and II above) is such as to render the issue as to interest no longer academic, the prayer of the petition in No. 29 (p. 5) is in the alternative—that this Court either "decide this petition [No. 29] or remand the case to the Circuit Court of Appeals for the Seventh Circuit to decide * * * on the merits."

[42] If this Court should reverse on Point I, but should agree with our contentions as to retroactivity under Point II and as to the interest item under this Point III, the Tax Court should be directed to modify its decision to the extent of requiring a decrease of basis in the amount of the accrued unpaid interest for the years 1935–1937 as well as 1938.

It is true that no evidence of tax benefits was before the Tax Court. However, the Tax Court found that the interest was due, and "was forgiven rather than transformed into stock" (R. 197), and no question is made as to the adequacy of the record to support this finding.[43] If the taxpayer desired to bring itself within the special exclusion of Section 270 for interest "not resulting in a tax benefit on any income tax return," the burden lay on it to establish the necessary facts. Since it failed to introduce any evidence on the issue, the Tax Court properly assumed the point in favor of the Commissioner. Whether or not it be true, as the taxpayer now urges (Br. in No. 29, pp. 23–25), that the record would have supported a factual inference that no income tax benefit had been taken, the failure of the Tax Court to adopt such an inference is clearly not grounds for review in the appellate courts. See *Helvering* v. *Ward*, 79 F. (2d) 381 (C. C. A. 8), and cases cited therein.

Nor is there merit in the taxpayer's claim that the interest question was not properly in issue in the Tax Court. The Commissioner based his position on Section 270, claiming that under that section the taxpayer's basis must be reduced to fair market value (R. 194–195). This claim

[43] The record did not disclose the amount of the interest thus forgiven, but the sum was determined by agreement of the parties under Rule 50 of the Tax Court (R. 206), and the accuracy of the computation has not been disputed.

placed on the Tax Court the duty of determining whether as a matter of law Section 270 applied in whole or in part. In determining that on the facts presented the section applied in part, the Tax Court was clearly determining a question placed in issue by the Commissioner. The taxpayer cannot be heard to complain merely because it failed to present facts sufficient to show its right to an exclusion from the statute's operation.

IV

THE ORIGINAL COST OF THE BUILDING AND THE PROPRIETY OF CERTAIN DEDUCTIONS CLAIMED FOR DECORATING EXPENSES WERE PURELY QUESTIONS OF FACT, ON WHICH THE TAX COURT'S FINDINGS SHOULD BE ACCEPTED AS CONCLUSIVE

The taxpayer in its petition in No. 29 assigns as additional error the refusal of the court below to reverse the findings of the Tax Court as to the original cost of the building,[41] and as to the propriety of certain small deductions claimed in 1937

[41] As with the question discussed in Point III, this question, which likewise relates only to the proper basis of the property in the hands of the taxpayer, is academic unless this Court rejects our view as to the cancellation or reduction of the principal of the bonds, or holds that Section 270 is totally inapplicable because the reorganization proceedings were no longer pending in 1938. The court below found it unnecessary to consider the question, although, as with the interest question (see footnote 40, *supra*), its mandate affirmed the Tax Court's decision on the point.

for decorating expenses.[45] Both questions were purely factual in nature, and in the state of the record neither presents any ground for reversal by a reviewing court. See *Dobson* v. *Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231.

(a) The Tax Court found (R. 184) that the original cost of the building to the Building Corporation was $385,326.37. In so finding, the Tax Court refused to include an alleged 10% contractor's commission of $38,516.91 on an asserted construction cost of $385,169.15 (R. 25–26),[46] basing its refusal on the ground that "the petitioner's witness failed to convince us that any amount was actually paid by the old company for contractor's services, or that the original stock issue in fact covered any more than the land" (R. 198).

We submit that the record discloses no ground to impeach the Tax Court's finding in this respect. The taxpayer's sole witness was Charles F.

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[45] The taxpayer also objects (Br. in No. 29, pp. 3, 28–a) that the Tax Court improperly permitted the Commissioner to change the rate of depreciation previously allowed for ten years "without any evidence to guide it and without this being an issue in the case." Since the rate thus previously allowed was 3% (Br. in No. 29, p. 28–a), and the rate allowed by the Commissioner in computing the deficiency here in litigation was 4% (R. 16), we are at a loss to understand the burden of the taxpayer's complaint.

[46] The difference between the asserted construction cost of $385,169.15 and the original cost found by the Tax Court ($385,326.37) is presumably to be accounted for by certain "odds and ends" claimed by the taxpayer as part of the original cost (R. 25–26). The total original cost claimed by the taxpayer, including contractor's commission, was $424,609.19 (R. 26, 184).

Henry, who had originally transferred the lot to the Building Corporation in return for its capital stock, and had then served as contractor to construct the building. He produced the Building Corporation's account book, which he had kept in his own handwriting, and testified that a pencil notation by him therein represented a "10 percent general contractor's profit" on a construction cost of $385,169.15 (R. 25-26). This scanty testimony clearly justified the Tax Court's reluctance to conclude that any contractor's commission had in fact been paid, so as to become a part of the cost of the building to the Building Corporation. Certainly the determination of the value of such equivocal testimony on a factual issue on which the taxpayer had the burden of proof is a matter peculiarly within the province of the Tax Court. Cf. *Beaumont* v. *Helvering*, 73 F. (2d) 110 (App. D. C.), certiorari denied, 294 U. S. 715.

The taxpayer asserts (Br. in No. 29, p. 18) that the Commissioner, having accepted for 15 years a basis for depreciation which included the contractor's commission in question, is "estopped at this late date to question this cost figure." The contention is without merit. The authority of the Commissioner to redetermine a tax liability is settled. *Burnet* v. *Porter*, 283 U. S. 230; *Virginian Hotel Co.* v. *Helvering*, 319 U. S. 523. So far as the argument asserts that, having passed the earlier returns, the commissioner in some

way disabled himself from later correcting his error, it is so plainly unsound as to need no discussion." *Seeley* v. *Helvering*, 77 F. (2d) 323, 324 (C. C. A. 2).

(h) The Tax Court also held that the taxpayer was not entitled to two small deductions in 1937 for decorating and repairs, because the same deductions for the same purposes had been claimed and allowed in 1936. The testimony offered on the issue of duplication of the deductions was vague and uncertain (R. 32, 68, 71). The issue was purely factual, and the circuit court of appeals was clearly right in saying (R. 237): "Our conclusion on this issue is that the evidence is conflicting, and we cannot disturb a finding which has evidence to support it." The same course should be followed by this Court.

CONCLUSION

The judgments of the circuit court of appeals should be affirmed on each of the issues involved.

Respectfully submitted.

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October 1944.

APPENDIX

Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, as amended by the Chandler Act of June 22, 1938, c. 575, 52 Stat. 840:

SEC. 268. Except as provided in section 270 of this Act, no income or profit, taxable under any law of the United States or of any State now in force or which may hereafter be enacted, shall, in respect to the adjustment of the indebtedness of a debtor in a proceeding under this chapter, be deemed to have accrued to or to have been realized by a debtor, by a trustee provided for in a plan under this chapter, or by a corporation organized or made use of for effectuating a plan under this chapter by reason of a modification in or cancelation in whole or in part of any of the indebtedness of the debtor in a proceeding under this chapter.

(11 U. S. C., Sec. 668.)

SEC. 269. Where it appears that a plan has for one of its principal purposes the avoidance of taxes, objection to its confirmation may be made on that ground by the Secretary of the Treasury, or, in the case of a State, by the corresponding official or other person so authorized. Such objections shall be heard and determined by the judge, independently of other objections which may be made to the confirmation of the plan, and, if the judge shall be satisfied

that such purpose exists, he shall refuse to confirm the plan.
(11 U. S. C., Sec. 669.)

SEC. 270 [as further amended by the Act of July 1, 1940, c. 500, 54 Stat. 709]. In determining the basis of property for any purposes of any law of the United States or of a State imposing a tax upon income, the basis of the debtor's property (other than money) or of such property (other than money) as is transferred to any person required to use the debtor's basis in whole or in part shall be decreased by an amount equal to the amount by which the indebtedness of the debtor, not including accrued interest unpaid and not resulting in a tax benefit on any income tax return, has been canceled or reduced in a proceeding under this chapter, but the basis of any particular property shall not be decreased to an amount less than the fair market value of such property as of the date of entry of the order confirming the plan. Any determination of value in a proceeding under this chapter shall not be deemed a determination of fair market value for the purposes of this section. The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe such regulations as he may deem necessary in order to reflect such decrease in basis for Federal income-tax purposes and otherwise carry into effect the purposes of this section.
(11 U. S. C., Sec. 670.)

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SEC. 276. * * *

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c. the provisions of sections 77A and 77B of chapter VIII, as amended, of the Act entitled "An Act to establish a uniform

system of bankruptcy throughout the United States", approved July 1, 1898, shall continue in full force and effect with respect to proceedings pending under those sections upon the effective date of this amendatory Act, except that—

(1) if the petition in such proceedings was approved within three months prior to the effective date of this amendatory Act, the provisions of this chapter shall apply in their entirety to such proceedings; and

(2) if the petition in such proceedings was approved more than three months before the effective date of this amendatory Act, the provisions of this chapter shall apply to such proceedings to the extent that the judge shall deem their application practicable; and

(3) sections 268 and 270 of this Act shall apply to any plan confirmed under section 77B before the effective date of this amendatory Act and to any plan which may be confirmed under section 77B on and after such effective date, except that the exemption provided by section 268 of this Act may be disallowed if it shall be made to appear that any such plan had for one of its principal purposes the avoidance of income taxes, and except further that where such plan has not been confirmed on and after such effective date, section 269 of this Act shall apply where practicable and expedient.

(11 U. S. C., Sec. 676.)

Article 22 (a)–14 of Treasury Regulations 86 under the Revenue Act of 1934, as amended by T. D. 4871, 1938-2 Cum. Bull. 130, 133:

ART. 22 (a)–14. *Cancellation of indebtedness.—(a) In general.*—The cancellation

of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22 (a)-18.) If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation.

(*b*) *Proceedings under Bankruptcy Act.*—Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act, as amended, of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, as amended, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. Furthermore, income is not realized in any case by a taxpayer in the case of a cancellation or reduction of his indebtedness under (1) a plan of corporate reorganization confirmed under section 77B of the Bankruptcy Act, as amended, or (2) a composition agreement confirmed under either section 12 or 74 of such Act. If, however, such plan of corporate reorganization or agreement of composition had for one of its principal purposes the avoidance of income tax, the cancellation or reduction of indebtedness, under such plan or agreement confirmed under section 12, 74, or 77B of the Bankruptcy Act, as amended, may result in the realization of income.

For adjustment of basis of certain property in the case of cancellation or reduction of indebtedness required by the Bankruptcy Act, as amended by the Act of June 22, 1938 (Public, No. 696, Seventy-fifth Congress), see article 113(b)-2.

Article 22(a)-14 of Treasury Regulations 94 under the Revenue Act of 1936, as amended by T. D. 4871, 1938-2 Cum. Bull. 130, 132:

ART. 22(a)-14. *Cancellation of indebtedness.*—(*a*) *In general.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by payment or purchase of his obligations at less than their face value. (See article 22(a)-18.) If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation.

(*b*) *Proceedings under Bankruptcy Act.*—Income is not realized by a taxpayer by virtue of the discharge, under section 14 of the Bankruptcy Act, as amended, of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of an agreement among his creditors not consummated under any provision of the Bankruptcy Act, as amended, if immediately thereafter the taxpayer's liabilities exceed the value of his assets. Furthermore, income is not realized in any case by a taxpayer in the case of a cancellation or reduction of his indebtedness under—

(1) a plan of corporate reorganization confirmed under either section 77B or Chapter X of the Bankruptcy Act, as amended;

(2) a composition agreement confirmed under either section 12 or 74 of the Bankruptcy Act, as amended;

(3) an "arrangement" or a "real property arrangement" confirmed under Chapter XI or XII, respectively, of the Bankruptcy Act, as amended; or

(4) a "wage earner's plan" confirmed under Chapter XIII of the Bankruptcy Act, as amended.

If, however, such plan of corporate reorganization or agreement of composition referred to in (1) to (4) above had for one of its principal purposes the avoidance of income tax, the cancellation or reduction of indebtedness, under such plan or agreement confirmed under section 12, 74, or 77B or under Chapter X, XI, XII, or XIII of the Bankruptcy Act, as amended, may result in the realization of income.

For adjustment of basis of certain property in the case of cancellation or reduction of indebtedness required by the Bankruptcy Act, as amended by the Act of June 22, 1938 (Public, No. 696, Seventy-fifth Congress), see article 113 (b)-2.

Article 113 (b)-2 of Treasury Regulations 86 under the Revenue Act of 1934, as added by T. D. 4871, 1938-2 Cum. Bull. 130, 134-135, and as amended by T. D. 5003, 1940-2 Cum. Bull, 107, 108-109:

ART. 113 (b)-2. *Adjusted basis: Cancellation of indebtedness.*—In addition to the adjustments provided in section 113 (b) (1)

and article 113 (b)-1 which are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in any case in which there shall have been a cancellation or reduction of indebtedness in any proceeding under section 12, 74 (except in the case of a "wage earner" as defined in the Bankruptcy Act, as amended), or 77B of the Bankruptcy Act of 1898, as amended. Such further adjustment shall be made in the following manner and order:

(1) In the case of indebtedness incurred to purchase specific property (other than inventory or notes or accounts receivable) whether or not a lien is placed against such property securing the payment of all or part of such indebtedness, which indebtedness shall have been canceled or reduced in any such proceeding, the cost or other basis of such property shall be decreased (but not below its fair market value) by the amount by which the indebtedness so incurred with respect to such property shall have been canceled or reduced;

(2) In the case of specific property (other than inventory or notes or accounts receivable) against which, at the time of the cancellation or reduction of the indebtedness, there is a lien (other than a lien securing indebtedness incurred to purchase such property) the cost or other basis of such property shall be decreased (but not below its fair market value) by the amount by which the indebtedness secured by such lien shall have been canceled or reduced;

(3) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced in such proceeding over the sum of the adjustments made under (1)

and (2) shall next be applied to reduce the cost or other basis of the property of the debtor (other than inventory and notes and accounts receivable, but including property covered by (1) and (2) as follows: The cost or other basis of each unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis (after adjustment under (1) and (2)) of each such unit of property bears to the sum of the adjusted bases (after adjustment under (1) and (2)) of all the property of the debtor other than inventory and notes and accounts receivable;

(4) Any excess of the total amount by which such indebtedness shall have been so canceled or reduced over the sum of the adjustments made under (1), (2), and (3) shall next be applied to reduce the cost or other basis of any units of property covered by (1), (2), and (3) which have a remaining basis (after adjustment under (1), (2), and (3) greater than their fair market value as follows: The cost or other basis of each such unit of property shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the remaining basis of each such unit bears to the sum of the remaining bases of such units. The process shall be repeated until the cost or other basis of each unit of the property covered by (1), (2), and (3) is reduced to its fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value; and

(5) Any excess of the total amount by which the indebtedness shall have been so canceled or reduced over the sum of the adjustments made under (1), (2), (3), and (4) shall next be applied to reduce the cost or other basis of inventory and notes and accounts receivable, as follows: The cost or other basis of inventory or notes or accounts receivable, as the case may be, shall be decreased (but not below its fair market value) in an amount equal to such proportion of such excess as the adjusted basis of inventory, notes receivable or accounts receivable, as the case may be, bears to the sum of the adjusted bases of such inventory and notes and accounts receivable. The process shall be repeated until the adjusted bases of inventory, notes receivable and accounts receivable are reduced to their fair market value or the amount by which the indebtedness shall have been canceled or reduced is exhausted, taking into account in the successive steps only those units of property having, after the preceding adjustment, a remaining basis greater than their fair market value.

For the purposes of this article—

(A) Basis shall be determined as of the date of entry of the order confirming the plan, composition or arrangement under which such indebtedness shall have been canceled or reduced;

(B) Except where the context otherwise requires, property means all of the debtor's property, other than money;

(C) No adjustment shall be made by virtue of the cancellation or reduction of any accrued interest unpaid which shall not

have resulted in a tax benefit in any income tax return;

(D) The phrase "indebtedness incurred to purchase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay; and

(E) The term "fair market value" has reference to such value as of the date of entry of the order confirming the plan, composition or arrangement under which such indebtedness shall have been canceled or reduced.

Any determination of value in a proceeding under the Bankruptcy Act, as amended, shall not constitute a determination of fair market value for the purposes of this article.

The basis of any of the debtor's property which shall have been transferred to a person required to use the debtor's basis in whole or in part shall be determined in accordance with the provisions of this article.

Article 113 (b)-2 of Treasury Regulations 94 under the Revenue Act of 1936, as similarly added and amended, is identical with Article 113 (b)-2 under Regulations 86, except that the last clause of the first sentence reads:

or 77B or under Chapter X, XI, or XII of the Bankruptcy Act of 1898, as amended.

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